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The Economic, Legal and Social Dimension of Regulatory Arbitrage

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Abstract: Regulatory arbitrage – the formal compliance with rules while violating their very spirit – is a persistent practice in daily business and subject of perpetual efforts of regulatory institutions to address this issue. Focusing on both, the practice of regulatory arbitrage as well as attempt of regulators and rule-makers seeking to contain it, the articles in this special issue provide a well-rounded, dialectical understanding of the phenomenon. In this vein, Friedrich zooms in on the construct of synthetic leasing as an example of a product, placed in zones of regulatory overlap between tax and accounting to achieve the most beneficial treatment. Kunkel discusses the political dimension of the conceptual underpinnings of financial reporting and how they are linked to regulatory arbitrage in accounting standards. Stanescu and Bogdan focus on tax sheltering in Romanian debt collecting schemes, just as Langenbucher explores the limits of constraining such practices provided by the need to grant a high degree of legal security, as enshrined in the rule of law. Lastly, Thiemann and Troeger inquire into how supervisors can keep up with financial innovations for regulatory arbitrage in the shadow banking sector, suggesting the need for a flexible interpretation of rules and close exchange with the regulated and their regulatory advisors to control their role bending behavior.

JEL Classification: H26, M41, M48, K42

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Economic, Legal and Social Dimensions of Regulatory Arbitrage

1. The Economic, Legal and Social Dimension of Regulatory Arbitrage, by Jan Friedrich and Matthias Thiemann, <https://doi.org/10.1515/ael-2020-0150>.
2. Regulatory Arbitrage: What's Law Got To Do With It?, by Katja Langenbucher, <https://doi.org/10.1515/ael-2019-0054>.
3. Regulatory Arbitrage and Non-Judicial Debt Collection in Central and Eastern Europe: Tax Sheltering and Potential Money Laundering, by Cătălin-Gabriel Stănescu and Camelia Bogdan, <https://doi.org/10.1515/ael-2019-0055>.
4. Ambiguities in Accounting and their Impact on Regulatory Arbitrage: A Study on the Anchoring of the Rights and Obligations Approach in the IASB's Conceptual Framework, by Tessa Kunkel, <https://doi.org/10.1515/ael-2019-0049>.
5. Regulatory Arbitrage in the Intersection of Accounting Standards and Tax Laws: The Case of Synthetic Leases, by Jan Friedrich, <https://doi.org/10.1515/ael-2020-0098>.
6. Detecting Tail Risks to Preclude Regulatory Arbitrage: The Case for a Normatively Charged Approach to Regulating Shadow Banking, by Matthias Thiemann and Tobias Tröger, <https://doi.org/10.1515/ael-2019-0059>.

1 Introduction

Few, if any phenomena, threatens the goal of law-makers, market regulators or accounting standard-setters to issue adequate rules and ensure their rigorous application as does regulatory arbitrage – the capacity of the regulatees to formally comply with the letter of a law while violating its very spirit in order to obtain a regulatory advantage (Fleischer, 2010). This is especially relevant in corporate affairs. Facilitated by the social construction of boundaries between regulations applicable to enterprise groups (Robé, 2011; Strasser & Blumberg, 2011), corporate agents and their professional advisors such as auditors and lawyers seek to bend rules in their favor (e.g. Shah, 1996, 1997) while creating negative externalities for other stakeholders and the society as a whole (Thiemann & Lepoutre, 2017). For instance, between 4 and 10% of the global corporate income tax revenues are subject to tax evasion (OECD, 2015: 4) due to tax base erosion and the shifting of profits across jurisdictions (see Avi-Yonah, 2017, Buettner & Thiemann, 2017 and the entire special issue on International Tax Avoidance in Accounting, Economics, and Law: A Convivium 7(1)). Another example is the accounting for lease agreements, resulting in USD 3 Trillion of off-balance-sheet liabilities – only under IFRS (IASB, 2016). Sophisticated financial instruments that bet on tail risks, threatening financial stability by reporting misleading risk assessments (Biondi et al., 2011; Thiemann, 2018). Another example is regulatory and supervisory arbitrage among different Central Clearing Counterparties (Friedrich & Thiemann, 2017, 2018a) in

which supervisors tolerate the gaming of risk models to create a competitive advantage for their national champions.

Different scholars from different disciplines, including tax law (Avi-Yonah & Pichhadze, 2017; Fleischer, 2010, 2012), banking law (Schwarcz, 2011), accounting (Bens & Monahan, 2008; Biondi, 2017; Donegan & Sunder, 1989; Dye, Glover, & Sunder, 2015; Friedrich, 2020a; Friedrich & Thiemann, 2018b), economics (Kane, 1988, 2008), socio-legal studies (Black, 2002, 2008; Riles, 2014) and sociology (Buettner & Thiemann, 2017; Thiemann & Friedrich, 2016) have sought to denote the dynamics of regulatory arbitrage. Socio-legal scholarship points to the distinction between legal form and economic substance, as well as to differences between legal form and practice (Awrey, 2013; Black, 2008). Accounting scholars have pointed to the relationship between precise rules and the strategies of managers to create a desired accounting outcome (Sunder, 2011). A political economy of regulatory arbitrage may ask whether and why some states or their sovereign agencies might aid and support these practices. This perspective may be complemented by scholars of professions which address the agents of rule circumvention (Christensen, Seabrooke, & Wigan, 2020; Whyte & Wiegatz, 2016) and their sometimes tense relationship with the states regarding the professional autonomy they enjoy.¹

As a result of this academic work, the regular patterns of the regulatory dialectic have been clarified, as well as its contextual parameters and its deleterious consequences. These works help to overcome the received assertions of post-structural sociology that at the core of regulatory evasion lay social conventions which are malleable at will. Instead, further investigations may ask: How does the institutional embedding of these regulatory evasion games intervene to structure them? What is the interest of political actors in maintaining these games? What are the ideological underpinnings permitting its continuation? What are the roles of financial and legal experts in the evasion of rules and in the formulation of laws which create or enable loopholes and structuring opportunities to circumvent them?

Confronted with an interdisciplinary phenomenon by nature, these remarkable investigation attempts were however somehow characterized by a lack of exchange between scholars and approaches. This thematic issue aims at overcoming this fragmentation. All its articles contribute to the debate on regulatory arbitrage from different disciplines, seeking to bridge the boundaries between accounting, economics and the law. Bringing these different approaches together, we propose to analyze regulatory arbitrage as a process in which various regulatory dimensions overlap, thereby, creating structuring opportunities for managers and financial

¹ Such relationships might be less tense in states such as Luxembourg, which actively advertise their flexibility in terms of rule interpretation.

engineers to get the best of all possible worlds for themselves (cf. Christensen et al., 2020). While this special issue focuses on different aspects at the intersection of accounting, economics, and law, all five articles are devoted to a common theme, namely to analyze regulatory arbitrage as a process to create this particular space of overlapping regulations, exploiting the under- and over-exclusiveness of written rules to optimally place their product (Black, 1997; Sunder, 2011).²

2 Regulatory Arbitrage at the Interplay of Accounting, Economics, and Law

In the attempt to shed light on the tense interplay between accounting, economics, and law, this special issue points to additional insights, which can be gained from such an interdisciplinary approach to the concept of regulatory arbitrage. Regulatory arbitrage as business practice seeks to place its outcomes at the intersection and interstices of regulations to achieve a more beneficial regulatory treatment, with regulatees seeking to disguise the economic substance of business transactions in a more beneficial legal form. As this special issue shows, an unregulated space arguably does not exist. Instead, regulatory arbitrage is located within those regulatory spaces, in which rules and regulatory categories overlap. This regulatory space exists at the cross-section of economic, accounting and legal scholarship, as Figure 1 illustrates.

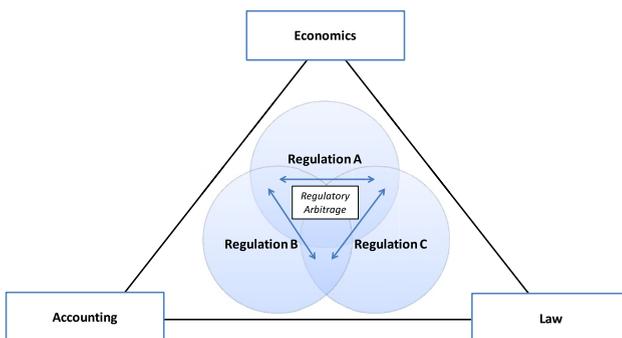


Figure 1: Regulatory arbitrage at the intersection of accounting, economics, and law.

² As is well known, no rule can specify *ex ante* all possible states of the world. It is hence under-inclusive. To the contrary however, it may also include certain cases which given certain circumstances should not be included (see Black, 1997).

This special issue represents a first attempt to examine regulatory arbitrage from a combined perspective, aiming to overcome existing boundaries between various disciplines. By analysing regulatory arbitrage from multiple angles this special issue includes five articles which seek to open new frontiers on the debate of this social practice, omnipresent in daily business.

3 Summary of Contents

Exploring the space of overlap from a legal perspective, Langenbucher's (2020) article examines the terminological and categorical dimensions of regulatory arbitrage from a legal perspective. The author calls for a more nuanced view on the phenomena of regulatory arbitrage by introducing a distinction between "repackaging arbitrage" (the domestic structuring of a transaction to avoid a regulation) and "moving-places arbitrage" (exploitation of regulatory differences between jurisdictions). By analysing several examples for repackaging and moving-places types of arbitrage, Langenbucher demonstrates that financial engineers draw upon a specific toolbox, depending on the respective forms the practice of regulatory arbitrage takes. She also outlines different approaches regulators can adopt to tackle this phenomenon while respecting the basic idea of the rule of law, which includes predictability of the rule for the regulatees.

The study by Stanescu and Bogdan (2020) focuses on debt-collection schemes in Central and Eastern Europe. It demonstrates the urgent need for strategies which can counter these rampant practices of regulatory arbitrage that threaten the capacity of states to collect tax debt while protecting their citizens from unlawful debt collections. Their study's object of inquiry brings together these two forms of regulatory arbitrage, then actually blurring the line between regulatory arbitrage and fraud. Debt-collection schemes allow participants to maximise their profits and to simultaneously minimise tax payments while the structure may also potentially serve as a vehicle for money laundering. By examining the functioning of debt-collection schemes in Romania, the authors shed light on a widely unknown part of the European shadow banking sector, which exploits regulatory loopholes and a lack of prudential supervision to engage in intra-EU cross-border regulatory and fiscal arbitrage. As the functioning of debt-collection schemes is a multi-party and cross-border undertaking, the authors call for further coordination among member states and supervisory agencies in the EU to mitigate regulatory and fiscal arbitrage.

Kunkel's (2020) study on the role of ambiguities in accounting connects the literature on the conceptual underpinnings of financial reporting with research on regulatory arbitrage. It analyses the patterns taken by the refinement of the asset

and liability definition in the IASBs conceptual framework from 2002 to 2018. His article shows how the Board aimed to dissolve alleged ambiguities in the definition of both financial elements by explicitly anchoring the underlying rights and obligations approach. This approach allows the componentization of financial elements and to tackle arbitrary bright line tests in accounting standards, prone to structuring activities by preparers of financial statements. Kunkel goes on to demonstrate how this reconceptualisation of assets and liabilities translates ambiguities, inherent to the rights and obligations approach, into the revised lease accounting standard, shifting the playing field of regulatory arbitrage from the exploitation of bright lines to the bending of interpretations.

Examining the case of synthetic leases, Friedrich's (2020b) article shows how precisely formulated accounting standards and tax laws can be exploited by financial engineers, allowing them to perpetually adapt to regulatory changes. In a synthetic lease, preparers seek to disentangle tax laws and accounting standards effects as the lease remains off-balance sheet for lessee's financial reporting purpose, while lessee's depreciations and interest expenses remain deductible for tax purposes. The article shows that tax laws may have facilitated regulatory arbitrage in the accounting realm (and vice-versa) by examining the evolution of synthetic lease structures under US-GAAP from their invention in the early 1990 to the recent revival of this off-balance sheet scheme under the new lease accounting standard ASC 842 under US-GAAP and its pendant IFRS 16. Using the case of synthetic leases, Friedrich proposes a coordinative regulatory setup, including accounting standard setters, prudential regulators as well as tax authorities to tackle regulatory arbitrage.

Along these lines, Thiemann and Troeger (2020) propose an innovative model of supervision that draws upon the expertise of both the regulatees and their regulatory advisors. The latter are incentivized to cooperate through a combination of threatened sanctions and advantages involved by exchange for clarification purposes, thereby closing the gap between relatively slow-moving supervisors and financial engineers which are able to quickly adjust to regulatory changes. Based on this improved understanding of financial innovations and their motivations, the authors then suggest a normative supervisory approach that is based upon who would pay for liabilities when tail risks materialize. Accordingly, regulatory and supervisory practices should be adjusted depending on this tail risk test; in line with the functional approach to regulation advocated by Merton, the authors suggest for financial innovations (including those generated for the purpose of regulatory arbitrage) to apply the same regulatory charges as those applied by activities undertaken by entities which fall within the realm of the "public safety net" such as depository institutions. The decision making criterion for this regulatory process is to ask whether the risks of financial innovations are borne by

regulated institutions if tail risks materialize and if so, to apply equivalent regulatory costs to these financial innovations such as core capital requirements, thereby destroying the regulatory advantages underlying those innovations.

4 Audience

Altogether, the studies contained in this special issue bring to the fore the need for coordination between regulators and the regulatees, as well as between various regulatory institutions and overlapping regulatory systems. These contributions are particularly relevant for the following audience: legal scholars, accounting scholars, and scholars of financial regulation.

Legal scholars can take from it an increased attention to spaces of overlap between different legal jurisdictions as the space where regulatory arbitrageurs operate. This is especially relevant for research on cross-jurisdictional regulatory shenanigans in the grey area between barely legal regulatory arbitrage and fraud. Accounting scholars can identify the need to integrate tax concerns in their analysis, in order to fully grasp new accounting constructs designed for regulatory arbitrage. This special issue is also important for researchers which investigate linkages and dynamics between the conceptual underpinnings of financial reporting (that is, the accounting model of reference), setting of specific accounting standards, as well as the adaption of regulatory arbitrage techniques. Researchers on the regulatory infrastructure of financial markets learn about the embeddedness of regulators and supervisors in different communities of expertise, in view to understand the evolution of regulation, while keeping in mind the dynamic nature of regulatory arbitrage and the driving forces behind it.

Given its investigation of various actors, institutions, and regulatory frames, this special issue is also relevant for policymakers, regulators and supervisors who seek to tackle the problem of regulatory arbitrage. To be successful, their efforts inevitably require an appreciation of the interdisciplinary nature of the phenomenon and, thus, an interdisciplinary approach to grasp it. Lawyers, accountants or regulators working alone on their respective sides will not suffice. Instead, their specific knowledge needs to be combined and might be complemented with an analysis of information flows over the interpretation of regulation, involving socio-economic analysis.

5 Further Perspectives

From this perspective, future research may focus on further linkages between accounting, economics, and law and examine the interplay with rule-making

institutions (cf. Friedrich, Kunkel, & Thiemann, 2020) that are brought about through the practice of regulatory arbitrage. For example, one could investigate how the translation of particular economic ideas into law or accounting – what has been called “economic transplants” (Langenbucher, 2017) – influences social practices that make up regulatory arbitrage. Other studies might investigate how civil or case law feeds into the practices of regulatory arbitrage in finance (Riles, 2011) or in taxation (Wigan, 2013). Much like the law and finance literature has done for the rule of law and its impact on economic growth (Deakin & Pistor, 2012; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998), this research avenue could consider the extent and form of regulatory arbitrage activities as its dependent variables.³ A particularly beneficial field of study might be the legal engineering in the realm of shadow banking in the wake of macro-prudential regulations, which seek to access the public safety net provided by central banks as lenders of last resort. The national implementation of these global macro-prudential rules and the local attempts at circumvention provide researchers with plenty of comparative material.⁴

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³ As the dependent variable becomes regulatory arbitrage activity and not growth, researchers can be assured of having a more direct causal chain linking these legal systems and the practices of legal engineering they evoke.

⁴ For the effect of prudential rules in Basel II on the structuring of securitization as a legal construct to circumvent these regulations, see Thiemann (2014).

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